

UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS
General Certificate of Education Advanced Level

BUSINESS STUDIES

9707/03

Paper 3 Case Study

October/November 2006

3 hours

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the Booklet. Write your Centre number, candidate number and name on all the work you hand in. Write in dark blue or black pen. You may use a soft pencil for any diagrams, graphs or rough working. Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A

Answer **all** questions.

Section B

Answer **one** question.

The businesses described in this question paper are entirely fictitious. Candidates are advised to spend 40 minutes on Section B.

At the end of the examination, fasten all your work securely together. The number of marks is given in brackets [] at the end of each question or part question.

LoCost Airways

The newspaper headline was quite clear:

“Another year of record profits for LoCost Airways”.

This airline was set up by Gavin Lara just five years ago. As a retired pilot for a major international airline he had become bored staying at home. He had met a friend, Sally Zhou, who owned her own small plane. They decided to offer flights to passengers to local towns and cities. Gavin and Sally had to meet certain legal requirements. Even after the cost of these was accounted for they were still able to charge much lower fares than larger airlines. They decided to create a private limited company, LoCost Airways, and lease two more aircraft and extend the routes they offered. They had to recruit other trained pilots – the business could not afford the cost of training new pilots itself. Now, after five years of rapid growth, record profits were being made. Sally and Gavin congratulated themselves on their success.

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Business expansion

LoCost Airways filled a gap in the market for low cost flights without the “extras” that added to other airlines’ costs. So, they did not offer food on board, charged passengers for all drinks and only allowed hand luggage on to the planes – no large bags could be carried. Tickets could only be bought via the Internet.

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Business success brought problems too. Gavin and Sally changed the organisational structure of the business several times as it grew. A senior management team was recruited and this added two levels to the hierarchy of the company. These changes had not been popular with staff who had become used to Gavin and Sally’s laissez-faire leadership style. The new management team insisted on quicker, centralised decision-making and this reduced discussions with staff.

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An appraisal system for pilots offers them substantial bonuses for good attendance and time keeping. The turnover of staff in other parts of the business has increased recently. One leaver was heard to say “we do not get paid as much as workers in bigger airlines but we no longer have the advantages of working for a small business”.

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Separate profit centres have been created for each route and for customer services (such as car hire and coach services to the airports). All of these profit centres are now achieving profits above budget – apart from the car hire division (see Appendix A). This newly established division recorded higher costs and lower revenue than expected.

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Future options

The business was now at a very important stage of its development. Sally had forecasted the demand for low priced flights for the next two years. She told Gavin: “I am confident that sales of our tickets will continue to rise by 20% for each of the next two years. We will need more aircraft to meet this demand. We may have problems recruiting enough extra staff of the right quality. I am also looking at opening up a new operating base at one of two airports, either in City X or City Y. The Finance Director has done some calculations for me to compare these two locations. (See Appendix C). Finance should not be a problem given our large cash reserves.”

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Gavin was pleased to hear this news but he had other ideas. He was not getting any younger and he wondered if he wanted the stress of owning an even bigger company. “I have been thinking. Instead of getting even bigger why not consider

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taking the airline “up market” to a different market segment? We could keep the same number of aircraft and staff but could charge higher fares for a better quality service. That way, we could increase our profit margins without doing much more work. The most important change we need to make to our marketing strategy to guarantee success is more promotion. But do I need to be worrying about things like this? I must say, the take-over bid from United World Airlines (UWA) seems really attractive now.”

The take-over bid

Two months ago Sally and Gavin had received a take-over bid from UWA of \$15 million for LoCost Airways. \$15 million! Just five years after setting the business up! Gavin was amazed at the value placed on his company. UWA did not currently operate in the “low cost” segment of the market. Many customers were being lost by airlines such as UWA to operators such as LoCost Airways. By taking over LoCost Airways it would have direct access to the existing customer base and it would eliminate one of its small competitors. Cash was not being offered – just shares in UWA. Gavin wondered how good an investment these would be compared to remaining an owner of LoCost Airways.

Appendix A

Car Hire profit centre. Actual / budgeted sales and costs. 01/11/05 – 31/10/06

	Budget \$000	Actual \$000
Sales Revenue	55	46
Variable costs	33	36
Promotion costs	5	3
Other overheads	13	15
Net Profit	4	(8)

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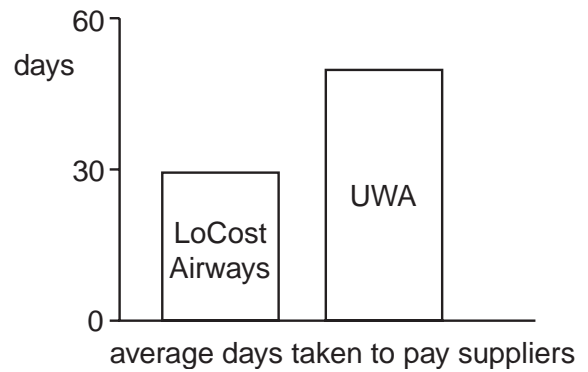
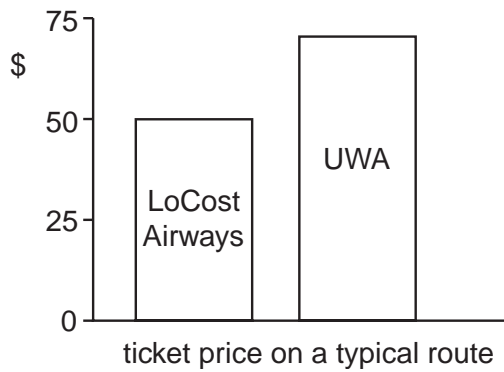
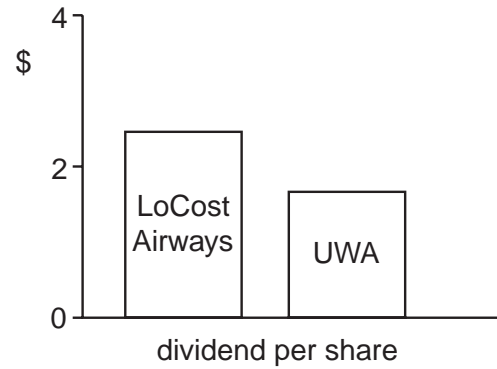
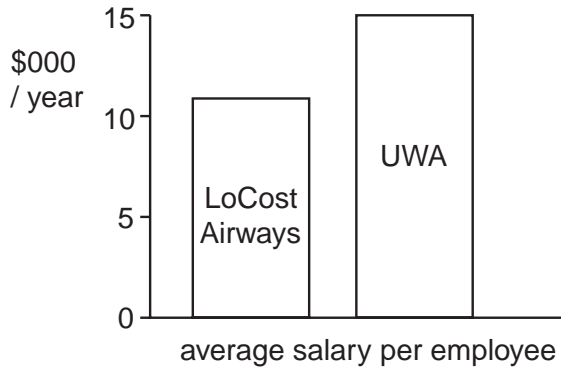
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Appendix B

Selected comparisons between LoCost Airways and United World Airlines. October



Appendix C

Analysis of alternative locations for a new LoCost Airways operating base.

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Forecasted:	City X	City Y
Annual fixed costs of site	\$2 million	\$ 1.5 million
Contribution per passenger	\$10	\$ 9
Capital cost of building (5 year lease)	\$2.5 million	\$1.4 million
Annual net cash flows (for first 5 years of operation)	\$1 million	\$ 0.5 million
Unemployment rate in the city	4%	12%
Number of airlines operating from airport	15	22

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Section A

Answer **all** questions in this section.

- 1 (a) Briefly explain how Sally might have forecasted demand for low priced flights for the next two years (line 37). [8]
- (b) Assess the usefulness of sales forecasting to LoCost Airways. [8]
- 2 (a) Using the data in Appendix A, calculate variances for the car hire division. [5]
- (b) Using your results from (a), analyse briefly why profits for the car hire division were less than budgeted. [5]
- (c) Discuss **two** ways in which this division might be made more profitable. [8]
- 3 The different stakeholder groups of LoCost Airways will be affected in very different ways if the firm is sold to UWA. Discuss whether it is in the best interests of LoCost Airways' stakeholders for UWA to take over the business. (You might find data in Appendix B helpful). [16]
- 4 Using the data in Appendix C and any other relevant information, recommend which city LoCost Airways should locate their next base in. Justify your answer. [16]
- 5 Gavin suggested taking the airline "up market" to a different market segment. To what extent do you agree with him that "the most important change we need to make to our marketing strategy to guarantee success is more promotion"? (lines 51-52) [14]

Section B

Answer **one** of the following questions.

- 6 The rapid expansion of businesses such as LoCost Airways often leads to problems with the management of people within the organisation. Evaluate how businesses could attempt to reduce these problems. [20]
- 7 Discuss the advantages and disadvantages to companies, such as UWA, of a strategy of continuous growth through integration with other businesses. [20]

